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INFO AMEMBASSY HELSINKI

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TAGS: OECD, ECON

SUBJECT: ECONOMIC AND DEVELOPMENT REVIEW COMMITTEE
(EDRC) REVIEW OF FINLAND

REF: (A) EDR(76)30, (B) OECD PARIS 33931

1. SUMMARY: IN REFDOC CIRCULATED FOR DECEMBER 13 EDRC REVIEW OF FINLAND SECRETARIAT UNDERLINES MARKED TENDENCY OF FINNISH ECONOMY TO LAG CYCLICAL DEVELOPMENTS IN OECD AREA. ACCORDING TO SECRETARIAT, FAVORABLE FINNISH CYCLICAL POSITION IN 1976 WAS MAJOR REASON FOR DRAMATIC IMPROVEMENT OF CURRENT ACCOUNT AND PRICE PERFORMANCE, ALTHOUGH RESTRICTIVE DEMAND MANAGEMENT POLICY CONTRIBUTED IMPORTANTLY TO BOTH DEVELOPMENTS. FOR 1977 SECRETARIAT SEES MODERATE GROWTH OF GDP, INCREASE IN UNEMPLOYMENT RATE, SOME DECELERATION OF INFLATION AND NO FURTHER REDUCTION IN CURRENT ACCOUNT DEFICIT. SECRETARIAT RECOMMENDS (A) CONTINUATION OF DEMAND MANAGEMENT RESTRAINT IN 1977; (B) USE OF TAX CONCESSIONS TO INDUCE MODERATION IN WAGE CLAIMS; (C) DEVELOPMENT OF MORE FLEXIBLE FISCAL POLICY INSTRUMENTS FOR COUNTER-CYCLICAL INTERVENTION. ACTION REQUESTED: MISSION WOULD APPRECIATE COMMENTS/QUESTIONS WHICH COULD BE USEFULLY POSED AT REVIEW.

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FOR HELSINKI: MISSION WOULD WELCOME EMBASSY COMMENTS ON SECRETARIAT ANALYSIS AND RECOMMENDATIONS.

2. SHORT-TERM PROSPECTS: DOMESTIC OUTLOOK: SECRETARIAT EMPHASIZES THAT TENDENCY OF FINNISH ECONOMY TO LAG CYCLICAL TRENDS IN OECD AREA AND STANCE OF GOF DEMAND MANAGEMENT POLICY LARGELY ACCOUNT FOR PATTERN OF FINNISH ECONOMIC GROWTH OVER LAST TWO YEARS. WHEREAS OECD AREA GNP DECLINED IN 1975, FINNISH FINAL DOMESTIC DEMAND ROSE RAPIDLY, SPURRED BY LAGGED EFFECTS OF EARLIER POLICY STIMULUS, WITH RESULT THAT REAL FOREIGN BALANCE AND CURRENT ACCOUNT POSITION DETERIORATED SHARPLY. EFFECTS OF RESTRICTIVE DEMAND MANAGEMENT POLICIES APPLIED IN 1975 TO COUNTER RAPID INFLATION AND TO REDUCE CURRENT ACCOUNT DEFICIT TOOK HOLD IN 1976. THUS, SECRETARIAT ESTIMATES THAT FINAL DOMESTIC DEMAND WILL DROP BY 3 PERCENT THIS YEAR. SECRETARIAT EXPECTATION IN MAJOR OECD COUNTRIES SHOULD PROVIDE STIMULUS TO EXPORTS. SECRETARIAT THEREFORE FEELS THAT IMPROVEMENT IN REAL FOREIGN BALANCE WILL PARTIALLY OFFSET DECLINE IN DOMESTIC DEMAND AND THAT REAL GDP WILL DECLINE BY ABOUT 0.5 PERCENT IN 1976.

3. FOR 1977, SECRETARIAT FORECASTS 2-3 PERCENT INCREASE IN REAL PRIVATE CONSUMPTION EXPENDITURE, EVEN IF WAGE INCREASES ARE MODERATE SINCE PLANNED REDUCTION IN DIRECT TAXES WILL BOOST DISPOSABLE INCOMES. HOWEVER, SECRETARIAT EXPECTS THAT SUBSTANTIAL SPARE CAPACITY, LOW PROFITS AND POOR STATE OF FIRMS' BALANCE SHEETS WILL RESULT IN STAGNATION OF BUSINESS FIXED INVESTMENT SPENDING. SECRETARIAT NOTES THAT STOCK MOVEMENTS IN 1977 ARE DIFFICULT TO FORECAST, BUT EXPECTS SOME ACCUMULATION TO TAKE PLACE AND ESTIMATES GDP GROWTH OF 4 PERCENT. SECRETARIAT STATES THAT GROWTH RATE OF 4 PERCENT WILL BE INSUFFICIENT TO OFFSET LAGGED EFFECTS ON LABOR MARKET OF POOR 1976 GROWTH PERFORMANCE AND THAT UNEMPLOYMENT IS LIKELY TO REGISTER FURTHER INCREASE.

4. WAGES AND PRICES: SECRETARIAT EXPECTS ONLY SMALL RISE IN IMPORT AND EXPORT PRICES IN 1977. THESE FACTORS TOGETHER WITH GOF DECISION TO "VIRTUALLY INDEX" TAX LIMITED OFFICIAL USE LIMITED OFFICIAL USE

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RATES WILL, IN SECRETARIAT VIEW, INCREASE LIKELIHOOD THAT JANUARY 1977 CENTRALIZED WAGE NEGOTIATIONS WILL RESULT MODERATE INCREASE IN NOMINAL WAGES. SECRETARIAT ALSO FEELS THAT GOF DECISION TO SHIFT TAX BASE AWAY FROM DIRECT TAXES AND TOWARD INDIRECT TAXES WILL HAVE NET ANTI-INFLATIONARY EFFECT. SECRETARIAT REASONING IS THAT MECHANICAL INCREASE IN CONSUMER PRICE INCREASE RESULTING FROM PLANNED INCREASE IN INDIRECT TAXES SHOULD BE MORE THAN OFFSET BY REDUCTION IN TAX-PUSH INFLATION (THROUGH

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WAGES) ENTRAINED BY CUTS IN DIRECT TAXES. SECRETARIAT
FORECASE 10 PERCENT IN PRICES (GOF DEFLATOR) NEXT YEAR.

5. CURRENT ACCOUNT: FACT THAT RECOVERY IN FINLAND
TRAILING THAT IN MAJOR OECD COUNTRIES (I.E., GROWTH IS
EIAT'S VIEW, LEAD TO REDUCTION IN CURRENT ACCOUNT DEFICIT
TO \$1 BILLION IN 1976 FROM \$2.2 BILLION IN 1975.
NEVERTHELESS, SECRETARIAT ESTIMATES THAT EXTERNAL DEBT
COULD REACH 21 PERCENT OF GDP BY END OF THIS YEAR.
FURTHERMORE, SECRETARIAT FORECASTS NO FURTHER REDUCTION
IN CURRENT ACCOUNT DEFICIT IN 1977. SECRETARIAT ADDS
THAT GOF GOAL OF REDUCING CURRENT ACCOUNT DEFICIT TO
2 PERCENT OF GDP BY 1980 WILL BE DIFFICULT TO ATTAIN
WITHOUT FURTHER SIGNIFICANT IMPROVEMENT IN FINNISH COST
PERFORMANCE.

6. ECONOMIC POLICY: SECRETARIAT NOTES THAT IN RE-
SPONSE TO RAPID INFLATION AND BURGEONING CURRENT ACCOUNT
DEFICIT, GOF MONETARY AND FISCAL POLICIES TURNED RESTRICTIVE
IN 1975 AND HAVE REMAINED SO IN 1976. SECRETARIAT
FEELS THAT GOF HAS NO CHOICE BUT TO RESTRAIN GROWTH OF
DOMESTIC DEMAND NEXT YEAR AS WELL.

7. SECRETARIAT PRESENTS ASSESSMENT OF IMPACT OF FINNISH
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FISCAL POLICY BETWEEN 1963 AND 1975 AND CONCLUDES AS
FOLLOWS: (A) IN SHORT RUN, AUTOMATIC STABILIZERS HAVE
HAD COUNTER-CYCLICAL EFFECT. DISCRETIONARY MEASURES
HAVE OFTEN HAD PRO-CYCLICAL IMPACT--BECAUSE OF LAGS AND
OF EFFORTS TO REDUCE BUDGET DEFICIT (I.E., PRESSURES TO
REDUCE SPENDING HAVE BEEN STRONGEST IN RECESSION WHEN
SLOW GROWTH OF REVENUES HAS TENDED TO WIDEN BUDGETARY
DEFICIT); (B) IN LONG RUN, GROWTH HAS BEEN RESTRAINED
BY STRONG FISCAL DRAG ELEMENT WHICH HAS SWAMPED DISCRE-
TIONARY EXPANSIONARY MEASURES; (C) FISCAL DRAG MAY HAVE
CONTRIBUTED TO TAX PUSH INFLATION.

8. BASED ON ANALYSIS OF DOC, SECRETARIAT SUGGESTS THAT
EDRC REACH FOLLOWING MAIN CONCLUSIONS:

(A) GOF DEMAND MANAGEMENT POLICIES SHOULD REMAIN RESTRIC-
TIVE IN 1977;

(B) GOF SHOULD CONSIDER OFFERING FISCAL CONCESSIONS TO
LABOR (ADDITIONAL TAX CUTS OR INCREASED TRANSFERS) TO
INDUCE MODERATION IN NOMINAL WAGE INCREASES;

(C) GOF SHOULD TAKE MEASURES TO INCREASE FLEXIBILITY OF
FISCAL POLICY AS COUNTER-CYCLICAL INSTRUMENT. IN THIS
CONTEXT IT WOULD BE DESIRABLE TO INCREASE EFFICIENCY OF
CORPORATE INVESTMENT RESERVE FUNDS;

(D) EXPECTED SLOWDOWN IN GROWTH OF WORLD TRADE WILL MAKE
RESTORATION OF FINNISH CURRENT ACCOUNT EQUILIBRIUM MORE
DIFFICULT. GOF MUST THEREFORE GIVE PRIORITY ATTENTION
TO GETTING INFLATION DOWN.

9. COMMENT: (A) SECRETARIAT NOTES THAT GOF HAS OFFERED
TAX CONCESSIONS IN THE PAST TO SECURE LABOR MODERATION
IN CONTEXT OF CENTRALIZED WAGE NEGOTIATIONS, BUT THAT
WAGE INCREASES NEGOTIATED AT INDIVIDUAL UNION AND PLANT
LEVELS HAVE GONE WELL BEYOND THOSE AGREED CENTRALLY.

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SECRETARIAT BELIEVES THAT WEAK LABOR MARKET IN 1977 SHOULD PREVENT SUCH A DEVELOPMENT NEXT YEAR. MISSION WOULD ARGUE THAT SECRETARIAT ANALYSIS IMPLIES THAT STATE OF LABOR MARKET IS MORE IMPORTANT DETERMINANT OF WAGE RATES THAN ARE GUIDELINES SET BY CENTRALIZED AGREEMENTS AND WOULD CONCLUDE THAT GOF SHOULD NOT DISSIPATE ITS LIMITED DEGREE OF FISCAL FLEXIBILITY BY ENGAGING IN TAX BARGAINING; (B) AT NOVEMBER 12 TWP MEETING ON EXTERNAL FINANCIAL POSITION OF SMALL OECD COUNTRIES (REF B) FINNISH REP WAS MORE OPTIMISTIC CONCERNING CURRENT ACCOUNT OUTLOOK FOR 1977 THAN WAS SECRETARIAT, BUT WAS NOT SPECIFIC--MISSION WOULD ASK FOR SPECIFICS. AT SAME MEETING FINNISH REP STATED GOF GOAL OF REDUCING CURRENT ACCOUNT DEFICIT TO 1 - 1.5 PERCENT OF GDP BY 1981. SECRETARIAT FEELS THAT ACHIEVEMENT OF THIS TARGET WILL BE DIFFICULT. MISSION WOULD QUESTION FINNISH DEL RE ASSUMPTIONS WHICH WOULD HAVE TO HOLD FOR CURRENT ACCOUNT TARGET TO BE ACHIEVED. MISSION WOULD ALSO APPRECIATE EMBASSY COMMENTS ON THIS QUESTION; (C) MISSION WOULD ASK FINNISH REP WHETHER PHASED ELIMINATION OF IMPORT DEPOSIT HAS PROCEEDED AS PLANNED DURING 1976.

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